Proponents argue that reductions in the work force, especially if accompanied by improvements in productivity, could foster improved operating procedures, more productive use of training programs, increased use of computers and other labor-saving equipment, and better agency management of human resources. Experience with cutbacks in nondefense programs reinforces such expectations. Requirements to cut the size of the work force might also encourage more far-reaching and often-proposed reforms, particularly at DoD. Such proposals, which usually entail high start-up costs, include restructuring major maintenance and supply activities, greater sharing of support services, closing or consolidating some facilities, and reorganizing the administration of defense contracts.

Opponents believe that using across-the-board reductions in employment in setting funding levels for agencies can be counterproductive. The goals themselves may not be realistic in view of the unique limitations and mission requirements of many activities, especially those relating to national security. Indeed, some observers believe that such goals would decrease the control and flexibility DoD managers need to maintain military readiness. Should agencies fail to find ways of improving productivity to compensate for employment cuts, the quality or level of services would decline. Other critics express concern about the uncertain costs of obtaining new equipment and of other measures to improve productivity. (The estimated savings presented in this option represent net amounts from the CBO baseline after allowing for substitution of capital investment for labor and other associated costs. For estimating purposes, such costs are assumed to be a one-time charge of 12 months' compensation for each workyear eliminated. Any additional implementation costs are assumed to be covered by reallocating existing funds.)

REVENUES

Federal revenues could be raised by changing existing taxes or by introducing new taxes such as a value-added tax or energy tax. This section presents 20 options for raising revenues from these sources. Revenues could also be raised by increasing taxpayer compliance with current law, as described below.

RAISING REVENUES FROM THE INCOME TAX

This year, options for changing the income tax must be evaluated in the context of the major revisions made by the Tax Reform Act of 1986 (Public Law 99-514, hereafter referred to as TRA). Before passage of TRA, an obvious way to raise revenues from the income tax was to curtail or eliminate tax preferences--the deductions, exclusions, and other provisions that reduce tax liability for selected taxpayers or activities. Most tax preferences reduced federal revenues significantly, and many were subject to challenge based on considerations of equity and efficiency.

TRA reduced the amount of revenue forgone because of tax preferences. It did this directly, by eliminating or limiting specific tax preferences ("base-broadening"). It also indirectly lowered the value of remaining tax preferences by reducing tax rates. The act also changed the distributional effects of some of the remaining tax preferences by targeting their benefits toward lower- and middle-income groups, contributing to the progressivity of the tax system. Finally, by reducing tax rates, the act also lessened the negative impact of tax preferences on the efficiency of the economy.

Many tax preferences remain, however. These include provisions that affect individuals, such as most itemized deductions and the exclusion from taxable income of employer-paid fringe benefits. A few preferences for businesses in specific industries also remain. Changes that could be made to current income-tax preferences are described in 14 of the revenue-raising options presented below.

TRA was designed to raise the same revenue from the income tax as under prior law, but it redistributes the tax burden. For many individuals, TRA's base-broadening provisions are more than offset by rate reductions: total revenues from the individual income tax in 1988 will be about $27 billion less than under prior law. For many corporations, TRA's changes will result in increased taxes: corporate tax payments in 1988 will be about $25 billion greater than under current law. Thus, TRA will shift some of the burden of the income tax from individuals to corporations.

Some people argue that revenues should be raised without changing the current distribution of the tax burden between individuals and corporations. This could be done by raising income tax rates across the board. This method of raising revenues is preferred by those who consider the distributional effects of TRA to be fair. Opponents of across-the-board rate increases argue that corporate taxes should not be raised in addition to the increases made by TRA. They point out that corporate tax increases are eventually passed on to individuals through changes in the value of corporate shares, in dividends, in wages, or in product prices. They are also concerned that corporate tax increases may have adverse effects on the economy.

Another argument against raising tax rates is that it might create public pressure to reinstate many of the tax preferences that were curtailed by TRA. The act was a compromise predicated on balancing reduced tax preferences against lower tax rates. Legislators (and taxpayers) who accepted this tradeoff in TRA might object if the rate reductions were reversed without corresponding increases in tax preferences.

Arguments can be brought against changing the income tax at all, whether through base-broadening or through rate increases. TRA was the fourth major income tax bill since 1980, following the Economic Recovery Tax Act of 1981 (Public Law 97-34), the Tax Equity and Fiscal Responsibility Act of 1982 (Public Law 97-248), and the Deficit Reduction Act of 1984 (Public Law 98-369). Both the government and taxpayers bear costs whenever the tax code is changed. For example, the government must revise its tax forms and instructions, issue new regulations, retrain IRS staff members, and make new tax court rulings; and taxpayers and their advisors must familiarize themselves with the new code. Tax law changes also cause windfall gains and losses for many taxpayers to the extent that changes in tax preferences and marginal tax rates affect the value of assets.

INCREASING TAX COMPLIANCE AND ENFORCEMENT

Another way to raise revenues would be to increase compliance with current tax laws. The Internal Revenue Service (IRS) estimates that the revenue loss from noncompliance is significant: in 1987, about $100 billion in taxes will go unpaid because of underreporting of income, overstatement of deductible expenses, failure to file, or failure to pay tax liabilities even when reported correctly. In addition to reducing federal revenues, noncompliance makes the distribution of the tax burden less equitable than the law intends, and gives those who fail to comply a competitive advantage in the economy.

On the other hand, increased enforcement has its costs. These include the costs of additional personnel and equipment, which must be diverted from other productive activities, and the costs to taxpayers who are already complying but may have to spend more of their time justifying their returns. Taxpayers may also view additional enforcement activities as government harassment and an invasion of privacy, which could reduce compliance over the long run. Some of the additional costs may be difficult to quantify, but they should be taken into account when deciding to increase enforcement.1/

Recent Congressional action has increased the appropriations for the IRS, specifically for activities designed to improve compliance. The IRS appropriation for 1987 was $422 million greater than the final 1986 appropriation and was $150 million more than requested in the President's budget. It provided funds to hire additional examination staff and other collections personnel, as well as to improve the reporting and processing of information, such as end-of-year wage statements prepared by employers or interest and dividend reports prepared by banks, investment firms, and corporations.

TRA and the Omnibus Budget Reconciliation Act of 1986 (Public Law 99-509) also provided for increased civil and criminal penalties and higher interest charges for noncompliance. In addition, some people argue that the tax rate reductions in TRA may also increase voluntary compliance, since they reduce the cost of reporting an additional dollar of income for most taxpayers.

The amount of revenues raised from compliance initiatives is not a simple function of the increase in IRS appropriations or of increases in tax penalties and interest. It also depends greatly upon administrative decisions within the IRS. For example, estimates of the revenues that an additional IRS examiner might raise vary from about $2 to about $20 per dollar spent on personnel, depending on whether the staff are assigned to simple or complex tax returns, to upper-income or middle-income tax returns, or to businesses or individuals. In addition to short-run revenue yield, administrative decisions are based on other factors, such as the need to examine returns

1. The costs and benefits of IRS enforcement activities are discussed in more detail in C. Eugene Steurerle, *Who Should Pay for Collectng Taxes? Financing the IRS* (Washington, D.C.: The American Enterprise Institute for Public Policy Research, 1986).

across all income levels in order to be perceived as fair and thus sustain voluntary compliance in the long run. The added revenue gain from additional IRS staff may also diminish as staffing levels grow, in part, because tax returns of each type that have the greatest potential revenue are pursued first. Additional uncertainty about the revenue yields from increases in IRS funding is caused by the legislative changes in 1986. Because of the uncertain results of future compliance initiatives, a description of alternatives to improve compliance is not included among the revenue-rais-ing options presented below.

The President's budget for 1988 includes a proposal to increase IRS funding by about $0.4 billion, a portion of which is proposed for improving enforcement. The Administration estimates that revenues will be increased by about $2.4 billion as a result of this funding.

SUMMARY OF THE REVENUE-RAISING OPTIONS

Option REV-01 describes alternatives for raising tax rates for individuals and corporations, while REV-02 describes the effects of repealing or postponing indexing of income tax rate brackets, standard deductions, and other values. REV-03 describes three variants of a federal value-added tax that could be imposed in lieu of increases in existing taxes. REV-04, REV-05, and REV-06 are alternative ways to raise revenues from federal excise taxes.

The next 14 options describe alternatives for broadening the income tax base. REV-07 through REV-10 would alter tax preferences aimed at particular activities or industries. REV-11 through REV-14 would reduce preferences that make some forms of saving more attractive than others. The remaining options for broadening the income tax base (REV-15 through REV-19) concern tax preferences that do not directly encourage saving or investment. The final option, REV-20, concerns ways to broaden the base of social insurance taxes.

The estimate of revenue gains from all of the options were made relative to the CBO baseline budget forecast. The baseline is developed under the assumption that most provisions of the tax code that are currently scheduled to expire will not be extended.

Most of the options have an effective date of January 1, 1988, since changes in income tax law are usually effective at the beginning of a new calendar year. For the excise tax options an earlier date of October 1, 1987, is assumed. A January 1, 1989, effective date is assumed for REV-03 (the value-added tax) because it seems unlikely that this option could be implemented before then.

REV-01 RAISE MARGINAL TAX RATES FOR INDIVIDUALS AND CORPORATIONS

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Addition
Individuals						
Retain Transitional 1987 Tax Rates for an Additional Year	8.6	7.0	--	--	--	15.6
Raise Marginal Tax Rates to 16 Percent and 30 Percent	14.0	27.4	29.6	32.4	35.5	138.8
Raise the Top Marginal Tax Rate to 30 Percent	7.0	14.2	15.5	17.4	19.7	73.8
Add a 33 Percent Bracket	2.8	6.5	8.8	11.4	14.1	43.7
Corporations						
Retain Transitional 1987 Tax Rate for an Additional Year	8.2	5.5	--	--	--	13.7
Raise Marginal Tax Rate to 35 Percent	1.5	2.6	2.9	3.1	3.3	13.4

Significant revenues could be raised by increasing marginal tax rates for individuals and corporations. Raising rates does not increase the complexity of the tax law, imposes no new recordkeeping requirements on taxpayers, and is easy for taxpayers to understand. Rate increases would, however, reduce incentives to work and save. They would also run counter to the changes in the Tax Reform Act of 1986, which will reduce statutory marginal tax rates significantly for both individuals and corporations (though the act also broadens the tax base). The rate reductions will be phased in, falling in both 1987 and 1988, and are so large that they could be partially reversed to raise large revenues while leaving rates well below those under prior law.

The net effect of the rate reductions and base broadening for individuals is that many taxpayers will have smaller tax liabilities, though some who previously made the greatest use of tax shelters or deductions will see increases in their tax bills. For corporations, the net effect is to raise taxes most for those that were previously able to avoid tax. The act increases the share of revenues to be paid by corporations in 1988 from 10.4 percent under prior law to 13.2 percent under current law. Because the act shifts the tax burden to corporations some people argue that it would be inappropriate to increase corporate taxes further.

Individuals. The income tax rate structure enacted in the Tax Reform Act will have two explicit marginal tax rates--15 percent and 28 percent--beginning January 1, 1988. (The marginal tax rate is the percentage of an extra dollar of income that a person must pay in taxes.) Taxpayers with taxable income in excess of specified levels may also pay a 5 percent surcharge, giving these taxpayers an effective marginal rate of 33 percent. The surcharge is the mechanism for phasing out the value of the 15 percent bracket and of personal exemptions as incomes rise. Taxpayers with incomes so high that the phaseout is complete pay no surcharge, and so face a 28 percent marginal rate. A five-bracket transitional rate structure will apply in 1987. For that year, the rates will range from 11 percent to 38.5 percent.

Maintaining the 1987 transitional rate structure, indexed for inflation, for an additional year would increase revenues by $8.6 billion in 1988 and by $7.0 billion in 1989. Increasing the marginal tax rates to 16 percent and 30 percent would increase revenues by about $139 billion in 1988 through 1992. Increasing only the top rate (to 30 percent) would raise revenues by about $74 billion over the five-year period. Replacing the implicit 33 percent tax bracket with an explicit 33 percent rate that applies to all income above the start of the phaseout of the 15 percent bracket would raise revenues by about $44 billion over five years.

Increasing marginal tax rates would raise a significant amount of money quickly and with few administrative complications. Because the bulk of individual income tax revenues is collected through payments withheld from employee paychecks, the added revenues from an increase in rates would flow into the Treasury as soon as employers changed their payroll accounting practices in accord with the new withholding rates (usually within one to three months).

There is much less difference between the highest and lowest income tax rates under current law than under previous tax law. Under the law prior to 1987, marginal tax rates ranged from 11 percent to 50 percent. Maintaining the 1987 transitional rate structure for an additional year or raising only the top marginal tax rate would increase taxes for upper-income families and reduce or leave unchanged taxes for low-income families. Raising the statutory rates to 16 percent and 30 percent would increase taxes for all families, but would result in a greater proportionate reduction in after-tax income for upper-income families than for low-income families. Adding a 33 percent bracket would raise taxes only for the small number of high-income families for whom the 15 percent bracket and personal exemptions would be completely phased out under current law.

Under any of these proposals the top marginal tax rate on ordinary income would be well below the top rate under the law before 1987. These proposals would, however, further increase the maximum rate on capital gains, which will be significantly higher under current law than under prior law. The maximum tax rate on capital gains will now be 28 percent beginning in 1987 compared with 20 percent under prior law. (Beginning in 1988, the maximum rate can be as high as 33 percent for families with taxable income in the rate adjustment or personal exemption phaseout range.) High marginal tax rates on capital gains could discourage investors from realizing gains. They could also discourage investment in high-growth ventures.

Maintaining the 1987 transitional rate structure for an additional year would reduce taxes for married couples with taxable incomes below $29,750 and raise taxes for those with incomes in excess of $46,280. With rates set at 16 percent and 30 percent, taxes for 1988 would increase by about 7 percent for most families. Raising only the top marginal tax rate (to 30 percent) would increase taxes for 1988 for married couples with taxable incomes over $29,750. The average taxpayer with an increase in taxes would pay 4 percent more. Adding a 33 percent bracket would increase taxes for 1988 by an average of 8 percent for the 400,000 taxpayers who would be affected. A married couple with two children would pay higher taxes under this option if their taxable income was $192,930 or higher.

Corporations. The Tax Reform Act reduces the top statutory rate on corporate income from 46 percent to 34 percent, beginning July 1, 1987. (Tax years that include July 1, 1987, will have a blended rate to prorate the reduction, so that calendar year corporations have a 40 percent rate in 1987.) Lower marginal rates will apply to the first $75,000 of taxable income, but corporations with taxable income above $100,000 will pay a 5 percent surtax until the benefits of the lower marginal rates have been phased out.

Maintaining the 40 percent rate for an additional year would increase revenues by \$8.2 billion in 1988 and \$5.5 billion in 1989. Increasing the marginal rate to 35 percent (beginning January 1, 1988) would increase revenues by about \$13 billion in 1988 through 1992.

Increasing the marginal tax rate would raise corporate taxes quickly without further complicating the corporate tax structure. Because the bulk of corporate tax payments are collected through quarterly estimated payments, the additional revenues could begin to flow into the Treasury during the quarter in which the increase was passed. Even a 40 percent rate would be a significant reduction for corporations that currently pay close to the statutory rate. It would be less favorable for investment, though, than current law.

An increase in the corporate rate could affect the decision a business makes about its form of organization. Businesses may be organized and taxed as corporations, in which case their income is taxed at both the corporate and individual levels. If they choose a noncorporate form, their income is only taxed at the individual level. The Tax Reform Act lowered the maximum individual income tax rate by more than the corporate rate, creating an unprecedented situation in which the corporate rate is higher than individual rates. If a later increase widened the distance between the corporate and individual rates, the incentive for corporations to reorganize in noncorporate form would be increased.

REV-02 AMEND OR REPEAL INDEXING OF INCOME TAX SCHEDULES

Addition to CBO Baseline	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1988	1989	1990	1991	1992	
Repeal Indexing	--	3.6	11.6	23.1	36.9	75.3
Eliminate the Indexing Adjustment Scheduled for 1989	--	3.6	6.3	7.0	7.7	24.6

Before the Tax Reform Act of 1986, the personal exemption amount, standard deduction (zero bracket), and tax brackets were adjusted annually to offset the effects of inflation. The act sets the dollar amounts of the standard deduction (including the extra standard deduction for the elderly or blind) and the tax brackets for 1987 and 1988, but indexes them for inflation in later years. The act sets the dollar amount of the personal exemption for 1987, 1988, and 1989 but indexes it thereafter. The act also indexes the amount and phaseout level for the earned income credit (EIC) for the first time. The options described below would not affect the indexing of the EIC.

Eliminating indexing would raise revenues by $75.3 billion in 1989 through 1992. Eliminating the indexing adjustment scheduled for 1989 would raise revenues by $24.6 billion in the same period. Changes in indexing would gain small amounts of revenue in the first year of enactment, but would raise considerably larger amounts in future years because of the cumulative effects of indexing.

Changes in indexing would raise the taxes of most taxpayers but would not increase taxes of very-high-income families whose tax liability does not depend on the personal exemption or the 15 percent bracket. (The Tax Reform Act phases out the benefits of these values for high-income taxpayers.) Families that use the standard deduction (generally low- and middle-income families) would be more affected by changes in indexing than families that itemize deductions.

The main argument for retaining indexing is that it requires the Congress to decide explicitly on tax increases. Without indexing, inflation causes more-than-proportional increases in tax liabilities as incomes rise;

this results in an increase in real tax liabilities without legislative action even though real income may not have increased or may even have fallen. Some people argue that these automatic tax increases give legislators an incentive to pursue inflationary policies, and they feel that indexing protects against this bias. Other opponents of inflationary policies prefer an unindexed tax code, arguing that tax increases caused by inflation will make inflationary policies less popular politically.

The revenue gains from either eliminating indexing or delaying indexing for one year would be highly sensitive to inflation. A one-percentage-point increase in the rate of inflation in excess of the predicted rate would increase the gains from eliminating indexing by about $24 billion over the five-year period.

REV-03 IMPOSE A VALUE-ADDED TAX

Addition to CBO Baseline a/	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1988	1989	1990	1991	1992	
5 Percent Tax, Comprehensive Base	--	73.8	107.5	110.9	114.3	406.5
5 Percent Tax, Narrower Base, Exemptions for Food, Housing, and Medical Care	--	42.6	62.1	64.0	65.8	234.6
5 Percent Tax, Narrower Base, No Exemptions for Food, Drugs, and Medical Care; Low-Income Relief Under Means-Tested Programs b/	--	56.0	81.5	83.3	84.7	305.3

a. Estimates based on effective date of January 1, 1989.

b. Includes increased outlays for Medicaid, Food Stamps, Medicare, Supplemental Security Income, and Aid to Families with Dependent Children.

A national value-added tax (VAT) could raise substantial revenue at relatively low tax rates. A VAT is typically administered by taxing the total value of sales of all firms, but allowing firms to claim a credit for taxes paid on purchases from other firms of raw materials, intermediate materials, and capital goods. Thus, firms pay tax on their wages, salaries, profits, and interest--their "value added."

A 5 percent tax on a comprehensive VAT base could raise an estimated $73.8 billion in fiscal year 1989 and roughly $400 billion over the 1988 to 1992 period, net of reduced income-tax revenues. A narrower-based VAT could net $42.6 billion in 1989 and over $230 billion between 1988 and 1992. These projections assume that collections would not begin until January 1, 1989, because the IRS estimates that it would take about 18 months after the date of enactment to begin to administer a VAT.

A comprehensive VAT base could exclude only those items that, if included, would make a VAT difficult to administer. A narrower base might exempt food, health care, and other expenditures. This comprehensive base is estimated to have been about $2.5 trillion and the narrower base about $1.5 trillion in 1986. (See the accompanying table.)

If a large amount of revenue is to be raised, a VAT might be preferable to an income-tax increase because it is neutral between present and future consumption, and therefore would not adversely affect incentives for saving and investment as much as an equal increase in income taxes. (Like an income tax, however, it would reduce rewards from work effort.) In addition, it would distort economic decisions less than would an equivalent increase in selective consumption taxes. Finally, surveys indicate that the public regards increases in sales taxes as a fairer way of raising revenue than increases in the income tax.

The major argument used against a VAT is that it is regressive when compared with annual income: the tax per dollar of consumption is the same for all taxpayers, but the ratio of consumption to income falls for people in higher income groups. Some analysts argue, though, that a better measure of regressiveness is to compare the tax with annual expenditures, which vary less than annual income and may be a better indicator of long-run income. Under this measure, a VAT appears less regressive (and some forms of VAT appear proportional).

In any case, a VAT could be made less regressive by allowing exemptions for goods and services consumed by low-income people, although such exemptions would substantially increase costs of enforcement and compliance and would reduce revenues from a VAT. One alternative for offsetting regressiveness would be to allow additional exemptions or credits for low-income people under the federal income tax, though this too would be costly. It would also increase the number of income tax returns filed, adding to the IRS workload.

Another alternative might be to include food and medical care in the narrower tax base, but to increase payments to low-income individuals through means-tested programs such as Medicaid, Aid to Families with Dependent Children (AFDC), Supplemental Security Income (SSI), and Food Stamps. Since medical care would be subject to the VAT, Medicaid and

Medicare benefits would automatically be adjusted to reflect the tax. A 5 percent increase in food stamp, AFDC, and SSI benefits would compensate low-income people for taxes on food, as well as partially offset taxes on other purchases. After accounting for the costs of these additional outlays, this option would reduce the deficit by about $80 billion (net) in 1990, and about $300 billion (net) in the years 1988 through 1992.

Other arguments against a VAT are that any increase in the price level it induces might have inflationary repercussions, and that states would regard a federal sales tax as interfering with their traditional revenue base. In addition, the large revenue-raising potential of a federal VAT is of concern to some people who fear it might facilitate undue growth of the federal government. Finally, a federal VAT would impose administrative costs on the firms paying the tax and claiming credits, and it would require new collection and enforcement personnel and procedures. (The Treasury Department has estimated that a VAT would require 20,000 additional personnel at an annual cost of about $700 million.)

SAMPLE CALCULATION OF A VALUE-ADDED TAX BASE, 1986

Items Included in Tax Base		Amount (In billions of dollars)	Gross Tax at 5 Percent Rate (In billions of dollars)
Total Personal Consumption in GNP		2,723	
Less:	Rent on housing	430	
	Net foreign travel expenditures	10	
	Religious and welfare activities	60	
Plus:	Monetary interest paid by individuals	91	
	New residential construction	170	
Comprehensive VAT Tax Base		**2,485**	**124**
Possible Exemptions for Narrower Base			
	New residential construction	170	
	All medical care	310	
	Food purchased for off-premises consumption	328	
	Food furnished to employees	8	
	Clothing issued to military personnel	0	
	Domestic services	10	
	Financial services provided free of charge	70	
	Expenses of handling life insurance	36	
	Local transit (excluding taxis)	4	
	Clubs and fraternal organizations	5	
	Private education and research	45	
Narrower VAT Tax Base		**1,499**	**75**

SOURCE: Congressional Budget Office.

REV-04 INCREASE ENERGY TAXES

Addition to CBO Baseline	Annual Added Revenues (billions of dollars) 1988	1989	1990	1991	1992	Cumulative Five-Year Addition
Impose Tax on Domestic and Imported Oil ($5 per barrel)	19.7	20.9	21.2	21.4	21.7	104.9
Impose Oil Import Fee ($5 per barrel)	8.1	7.2	7.2	7.7	8.4	38.5
Increase Motor Fuel Tax (12 cents per gallon)	10.6	11.1	10.9	10.8	11.0	54.4
Impose Broad-Based Tax on Domestic Energy Consumption (5 percent of value)	13.4	15.0	16.1	17.0	18.3	79.8

NOTE: These added revenues are net of estimated changes in income, windfall profit, and other taxes. Induced outlay effects are not estimated. The revenue estimates are based on CBO's baseline oil price forecast of $15.30 per barrel in 1988, rising to $17.60 per barrel by 1992. If oil prices differ from this forecast, revenues may be significantly affected. The effective date for all of these proposals is October 1, 1987.

Energy taxes could raise significant amounts of revenue, reduce the country's dependence on foreign oil suppliers, and increase conservation by making energy more expensive. The United States depends on foreign sources for about 29 percent of the oil it consumes, and about 19 percent of its total energy. This dependence exposes the U.S. economy to potential supply interruptions.

Raising energy taxes might lead to reduced energy consumption so that the costs of supply interruptions would diminish. Moreover, reduced demand for imported oil resulting from an energy tax could force foreign suppliers to absorb part of the tax through lower prices. Finally, energy taxes (by raising energy prices) would help preserve the conservation gains that have been achieved in recent years and that might otherwise be lost because of recent declines in world oil prices.

One argument against energy taxes is that they would absorb a larger fraction of family incomes for low-income taxpayers who spend a relatively high percentage of their incomes on energy. Some analysts counter with the argument that the regressiveness of the tax should be measured against annual expenditures, not income, because expenditures are a better reflection of long-run income. Using this measure, energy taxes appear less regressive. Whichever measure is used, the regressiveness of energy taxes could be offset by small adjustments in income tax rates or by providing energy stamps for low-income people.

Concern has been expressed over the use of energy taxes on several other grounds. Energy taxes could have widely different effects in different parts of the country. For example, one study indicates that taxes that increase the relative price of fuel oil would have the greatest impact on the Northeast region, while taxes that increase the relative price of gasoline would have the greatest impact on the West.1/ In addition, if the imposition of energy taxes raises the Consumer Price Index, indexed federal outlay programs would be affected. Some observers have also argued that stockpiling oil is a more cost-effective way of relieving dependence on imports and would not artificially reduce current energy use by households and businesses. This argument follows from a view that free markets already provide sufficient incentives for resource conservation.

Excise Tax on Domestic and Imported Oil. An excise tax on all oil--both domestically produced and imported--could raise substantial revenue. A $5-per-barrel tax would raise about $21 billion per year and would increase the price of a barrel of oil by about 42 percent or the price of a gallon of gasoline by about 12 cents. Only a portion of the tax would be paid by U.S. consumers or producers. Because the tax would drive down world oil prices, foreign suppliers would also bear part of the burden.

A tax on oil would increase the price that consumers must pay, giving them an incentive to use less oil either through conservation efforts or by switching to an alternative source of energy such as natural gas or coal. Suppliers of oil (both domestic and foreign) would receive a lower after-tax price and so have an incentive to reduce production.

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1. Congressional Budget Office, *The Budgetary and Economic Effects of Oil Taxes* (April 1986).

Since 1981, the average cost of a barrel of oil has dropped from about $35 to under $20. A $5 per barrel oil tax would partially offset this price reduction and help retain incentives for energy conservation efforts and for production from alternative energy sources. The tax would still leave consumers paying significantly lower prices than six years ago. The tax would, however, further depress the after-tax prices that suppliers of oil receive.

Oil Import Fee. As an alternative to an excise tax on all oil, the Congress could impose the tax only on imports. This type of tax was a topic of discussion during the deliberations over the budget resolutions for fiscal years 1986 and 1987. An oil import fee of $5 per barrel would raise about $7 billion per year.

An oil import fee would allow domestic suppliers to charge a higher price and still remain competitive with imports, which would provide an incentive to increase domestic production of oil. Like the tax on all oil, the fee would also serve to maintain conservation incentives by holding up energy prices. These effects would reduce U.S. dependence on foreign oil in the short term, although long-term dependence might be increased if U.S. oil supplies were depleted faster. Some oppose an oil import fee on this basis: they see it as a policy of "draining America first." (This argument is also made regarding tax incentives for extractive industries; see REV-09.) They argue that the United States should take advantage of cheap foreign oil to preserve more expensive U.S. reserves for future use.

With the spot price of oil currently under $19 per barrel, the $5 fee would still leave the total price of oil well below 1981 levels. As with the tax on all oil, U.S. consumers would pay only part of the fee; the rest would be borne by foreign suppliers, who would face a lower world oil price as a result of the tax. One consequence is that some important U.S. trading partners might object to the fee (though others would benefit from a lower world oil price). Exempting oil imports from selected countries such as Canada, Mexico, and the United Kingdom would substantially reduce the fee's revenue potential. Imports from these countries now account for about one-third of U.S. oil imports.

An oil import fee would have different effects in different regions of the country. It would benefit oil-producing states, because producers would receive higher prices, but oil-consuming states--especially in the Northeast--would bear much of the burden of the tax and of the higher prices U.S. oil producers receive.

Additional Motor Fuel Excise Tax. The present federal tax on gasoline and other highway motor fuels is 9 cents per gallon. The revenue from this tax is earmarked for the federal Highway Trust Fund, which pays for construction and improvement of highways, bridges, and mass transit facilities. State governments also impose gasoline taxes ranging from 7 cents to 18 cents per gallon. Compared with other countries, many of which levy taxes of well over $1.00 a gallon, the United States charges one of the lowest tax rates on motor fuel in the world.

An additional federal tax on motor fuels would raise about $0.9 billion per year for each cent per gallon of tax. Because the average national price of gasoline has dropped from a peak of about $1.39 a gallon in March 1981 to about $0.84 in October 1986, an additional tax of 12 cents per gallon would not put the total cost of gasoline above what consumers have already experienced. If proceeds from the additional tax were allocated to general revenues instead of being used to support additional spending from the Highway Trust Fund, they could result in deficit reduction.

Beyond raising revenue, an additional excise tax on motor fuel would reduce consumption of gasoline and diesel fuel and dependence on foreign oil by encouraging people to drive fewer miles or purchase more fuel-efficient cars and trucks. The excise tax would not significantly affect oil consumption for other purposes, such as electricity production or home heating. An argument against a motor fuel tax increase is that it would impose an unfair burden on people who commute long distances by car, compared with other users of energy. The tax would also affect consumers in the southern and western states more than those in other regions.

Broad-Based Tax on All Energy. An alternative to selective excise taxes is a broad-based tax on all forms of energy consumption, whether produced domestically or abroad. A national energy tax would heighten conservation incentives and reduce consumption of all forms of energy. Further, because the tax would apply to all energy sources, it could raise much more revenue at a lower rate than selective taxes. The tax could be imposed as a fraction of the value of fuel, or could be based either on units produced (such as barrels of oil, tons of coal, or cubic feet of gas) or on the heat content of the fuel measured in British thermal units. Unlike a Btu or per unit tax, a tax on energy value would not change relative fuel prices and would not encourage consumers to switch from one form of energy to another. A 5 percent tax on the value of all domestic and imported energy consumption, including coal, petroleum, natural gas, hydroelectricity, and nuclear power, would raise over $16 billion per year in revenues.